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In the

Supreme Court of the United States

OCTOBER TERM, 196....

No. 433

THE SHAMROCK OIL AND GAS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented for review	2
Depletion issue	2
Bonus issue	2
Statutes and regulations involved	3
Statement	3
Reasons for granting the writ	5
Depletion issue	5
Bonus issue	9
Conclusion	19
Certificate of service	20
Appendix	A-1

Page

Cases:

Alabama By-Products Corp. v. Patterson, 151 Fed. Supp. 641, affirmed 258 Fed. 2d 892 8

Anderson v. Helvering, 310 U.S. 404 ..... 10, 12

Arkansas Natural Gas Co. v. Sartor, 78 Fed. 2d 924, cert. den. 296 U.S. 656 8

Burnet v. Harmel, 287 U.S. 103 ..... 10, 11

Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 ..... 10, 16

Douglas v. Commissioner, 322 U.S. 275 ..... 12, 15

Eisner v. Macomber, 252 U.S. 189 ..... 9, 10

Foster v. Atlantic Refining Co., 329 Fed. 2d 485 8

Henderson Clay Products Co. v. U.S., 324 Fed. 2d 7 8

Murphy Oil Co. v. Burnet, 287 U.S. 299 ..... 10, 12

Palmer v. Bender, 287 U.S. 551 12

Phillips Petroleum Co. v. Bynum, 155 Fed. 2d 196, 201, cert. den. 329 U.S. 714 8

Phillips Petroleum Co. v. Ochsner, 146 Fed. 2d 138 8

Riverton Lime & Stone Co. v. Commissioner, 28 T.C. 446 8

Page

Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620 8

Sartor v. Arkansas Natural Gas Corp., 134 Fed. 2d 433 8

Sartor v. United Gas Public Service Co., 84 Fed. 2d 436 8

Shamrock Oil and Gas Corporation, The, v. Coffee, 140 Fed. 2d 409, cert. den. 323 U.S. 737 8

Standard Realization Co. v. U. S., 289 Fed. 2d 247 8

United States v. Cannelton Sewer Pipe Company, 364 U.S. 76 7

U. S. Pipe & Foundry Co. v. Patterson, 203 Fed. Supp. 335 8

U. S. Salt Corp. v. Commissioner, 40 T.C. 359, affirmed 339 Fed. 2d 215 8

Woodward Iron Co. v. Patterson, 173 Fed. Supp. 251 8

Statutes and Regulations:

Internal Revenue Code of 1939

Sec. 23(m) 3, 17

Sec. 114(b)(3) 2, 3, 5

Treasury Regulation 111

Sec. 29.23(m)-1(f) 3, 5

Sec. 29.23(m)-10(a) 3

Page

Treasury Regulation 118
Sec. 39.23(m)-1(e) 3, 4, 5
Sec. 39.23(m)-1(e)(3) 8
Sec. 39.23(m)-1(f)(5) 3
Sec. 39.23(m)-10(a) 3

Miscellaneous:
Black's Law Dictionary 7
Constitution of the United States
Art. I, Sec. 2, Clause 3 9
Art. I, Sec. 9, Clause 4 9

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THE SHAMROCK OIL AND GAS CORPORATION petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 1060)[1] is reported at 35 T.C. 979. The opinion of the Court of Appeals (A. 5) is not yet reported.

[1] "R." refers to the Transcript of Record filed in the Court of Appeals. Nine copies of the printed record below are being filed with the Clerk. "A" refers to the Appendix to this petition.

JURISDICTION

The judgment of the Court of Appeals was entered June 7, 1965 (A.-15). Petitioner's Petition for Rehearing was denied July 9, 1965 (A.-16). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED FOR REVIEW

Depletion Issue

What is the "gross income from the property" under Section 114(b)(3) of the Internal Revenue Code of 1939 of an integrated natural gas producer-processor with respect to its produced and processed gas, and how is the "representative field or market price (as of the date of sale)" of such gas to be determined under applicable regulations defining "gross income from the property."[2]

Bonus Issue

Whether a cash bonus paid by the taxpayer in connection with the execution of an oil and gas lease is to be excluded from gross income in determining taxable income.

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[2] The following related questions pertaining to the depletion issue, though not separately discussed, are preserved:

Whether, within the meaning of the statutory and regulatory provisions, the "gross income from the property", with respect to petitioner's gas, should not be ascertained at the wells by determining the actual income received by petitioner for its gas at the wells under the undisputed and stipulated record through appropriate accounting methods.

Whether the sales of gas evidenced by Exhibits 29 and 30 should not, as a matter of law, be included in the list of sales contracts directed by the courts below to be used in determining the "representative market or field price" of petitioner's gas.

In the alternative, if the cash bonus is not to be excluded from gross income in determining taxable income, whether such bonus similarly is not to be excluded from gross income in determining statutory depletion.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in Appendix (A.-1-4). They are as follows: Sections 23(m) and 114(b)(3) of the Revenue Code of 1939; Sections 29.23(m)-1(f) and 29.23(m)-10(a) of Treasury Regulation 111; and Sections 39.23(m)-1(e), 39.23(m)-1(f)(5) and 39.23(m)-10(a) of Treasury Regulations 118.

STATEMENT

This income tax case originating in the Tax Court involves deficiencies for taxpayer's fiscal years ending November 30, 1943 through 1954. A writ of certiorari is sought to the Court of Appeals from the affirmance of the Tax Court on the two controverted issues, designated by both courts below and hereafter designated as the Depletion Issue and the Bonus Issue.

The Depletion Issue involves the question of what is the "gross income from the property" within the meaning of Sec. 114(b)(3) of the 1939 Internal Revenue Code with respect to the raw gas produced by petitioner and processed in its gasoline extraction plants for the removal of the liquid hydrocarbons before the residue gas was sold. The courts below held that under Reg. 111, Sec. 29.23(m)-1(f) and Reg.

118, Sec. 39.23(m)-1(e), "the gross income from the property" of taxpayer's gas should be assumed to be the "representative market or field price (as of the date of sale)" of taxpayer's gas at the wells where produced.

Holding that "prevailing field price" was the meaning of "representative market or field price" in the Regulations, the courts below held that such price should be determined by the weighting of prices paid during the respective tax years for deliveries of gas at the wells under prior executed contracts, whenever executed. Many of the contracts included in the tabulation in the formula had been negotiated at remotely earlier times when, as found by the Tax Court, the prices then agreed upon were lower, due to the economic and other conditions then prevailing, than like gas commanded at later dates during the tax years in issue. This difference in price was, as found by the Tax Court, due in part to the limited and lower valued uses to which sour gas could be put, which limitations were removed through the development of a sweetening process during the tax years involved, by which such gas became desirable and usable for higher valued purposes.

The Bonus Issue involves the question of how the lessee-payor (petitioner) should treat, for tax purposes, the cash bonuses paid for the acquisition of oil and gas leases in which it became the lessee. The courts below held that the lessee-payor could neither exclude nor deduct such cash bonuses from taxable income, either in the year when paid, or on an allocate basis over the productive life of the lease, but on the contrary must deduct an allocate part of such bonus

payment, based on the anticipated productive life of the lease, from the income from production from such lease before computing statutory percentage depletion on the remaining income from production from such lease. All facts relating to the bonus issue are stipulated.

REASONS FOR GRANTING THE WRIT

Depletion Issue

The depletion issue presents an important question of Federal tax law which has not been but should be decided by this Court since under the decisions below a special formula, applicable only to natural gas production, has been adopted, which conflicts with prior decisions defining "market price" and is at variance with the definition of "representative market or field price" as applied to other minerals under similar regulations.

Even if, as both courts below held, "the gross income from the property" of petitioner's gas production, on which it is entitled to compute percentage depletion under the Internal Revenue Code,[3] is, under the applicable regulations,[4] to "be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation," the formula devised by the Tax Court to determine such price is erroneous and results in a price that is neither "representative" nor a "market price".

[3] Sec. 114(b)(3) of 1939 Code.

[4] Reg. 111, Sec. 29.23 (m)-1(f); Reg. 118, Sec. 39.23(m)-1(e).

During all taxable years the major portion of petitioner's gas production was sour gas. The Tax Court properly found: that prior to the development of the Girbitol process for the sweetening of sour gas[5] such gas would not be purchased by pipeline companies because it was unsuitable for pipeline purposes and that the only use for sour gas was for carbon black manufacture, for which use the carbon black companies paid a lower price;[6] but during the years here involved there was an evolution with respect to the use of sour gas and after the development of the sweetening process sour gas became a highly desirable source of supply for pipelines;[7] that with the increasing demand for gas and the development of the sweetening process, both raw sour gas and sweetened sour gas residue became desirable and the price for which gas could be sold at the wellhead and for residue gas in the Texas Panhandle moved upward.[8]

Notwithstanding such findings the Tax Court, with the Court of Appeals affirming, directed that lower contract prices, negotiated during such earlier years when sour gas was not usable for pipeline purposes, should be included in a weighting of prices to determine a representative market price for gas later discovered, produced, used and sold for pipeline purposes during periods when like gas was being sold and purchased at the wellhead for much higher prices than those obtainable at the dates the earlier contracts were negotiated.

[5] The first deliveries of sweetened sour residue gas made in the Texas Panhandle began in 1947, 35 T.C. 1010 (R. 1129).

[6] 35 T.C. 1014, 1015 (R. 1139-1140).

[7] 35 T.C. 1016 (R. 1144).

[8] 35 T.C. 1017 (R. 1145).

By so holding and in refusing to sustain petitioner's contention that "the representative market or field price," if determinative, should be based on sales of gas comparable in quantity, quality, available usages and other conditions, entered into during or near the respective taxable years involved, the courts below adopted a formula which, by the Tax Court's own admission, can effect a "substantially different result."[9]

By failing and refusing to determine the "representative market or field price" of gas by prices negotiated for comparable gas, under comparable conditions, during or near the taxable year during which the representative market price is to be ascertained, the courts below violated and disregarded established principles of law that market price is to be established by current sales of comparable products.

The opinions below violate the teaching, if not the direct holding, of this Court in *United States v. Cannelton Sewer Pipe Company*, 364 U. S. 76. In *Cannelton* this Court held that the gross income of an integrated mining-manufacturer of clay sewer pipe should be determined by the amount that ordinary miners — not integrated — would sell their product. This Court found substantial *current* sales of such a product from which a price could be determined.

The standard definition of market price puts emphasis on *current* and *recent* sales of like products.[10] Court decisions dealing with the market price of gas likewise recognize that

[9] 35 T.C. 1037 (R. 1204).

[10] Black's Law Dictionary defines market price as, "The price actually given in current market dealings, and actual price at which given commodity is currently sold, or has recently been sold in open market * * *"

for a sale to be considered as fixing market price it must be a current or recent sale, as well as comparable as to usages, quantity, quality and other factors having a bearing on the price willing buyers and sellers would agree upon.[11]

In *Foster v. Atlantic Refining Co.*, 329 Fed. 2d 485, it was held that the market price of gas is not fixed by the amount that such gas was sold at an earlier date under a long term contract, even though such price was the best price then obtainable, but by the prices agreed upon in contracts negotiated at later times when the market price was to be ascertained.

The phrase "representative market or field price" in regulations applicable to minerals other than oil and gas[12] has been held to refer to sales of comparable minerals made during the taxable period in which such price is to be ascertained. In such decisions emphasis is put on the products being of "like grade and quality".[13] Where the "representative market or field price" of gas is determined by including

[11] *Phillips Petroleum Co. v. Bynum*, 155 Fed. 2d 196, 201, cert. den. 329 U.S. 714, where it is stated "Market price of gas is determined by sales of gas, comparable in time, quantity, quality, and availability to marketing outlets." *The Shamrock Oil and Gas Corporation v. Coffee*, 140 Fed. 2d 409, 410, cert. den. 323 U.S. 737; *Phillips Petroleum Co. v. Ochsner*, 146 Fed. 2d 138; *Arkansas Natural Gas Co. v. Sartor*, 78 Fed. 2d 924, cert. den. 296 U.S. 656; *Sartor v. United Gas Public Service Co.*, 84 Fed. 2d 436; *Sartor v. Arkansas Natural Gas Corp.*, 134 Fed. 2d 433; *Sartor v. Arkansas Natural Gas Corporation*, 321 U.S. 620.

[12] Reg. 118, Sec. 39.23(m)-1(e)(3).

[13] *Riverton Lime & Stone Co. v. Commissioner*, 28 T.C. 446; *Alabama By-Products Corp. v. Patterson*, 151 Fed. Supp. 641, affirmed 258 Fed. 2d 892; *Woodward Iron Co. v. Patterson*, 173 Fed. Supp. 251; *Standard Realization Co. v. U.S.*, 289 Fed. 2d 247; *U. S. Pipe & Foundry Co. v. Patterson*, 203 Fed. Supp. 335; *U. S. Salt Corp. v. Commissioner*, 40 T.C. 359, affirmed 339 Fed. 2d 215; *Henderson Clay Products Co. v. U. S.*, 324 Fed. 2d 7.

earlier sales when, because of its objectionable hydrogen sulphide content, sour gas was not available for pipeline usages, the price so determined is not the current price for the higher valued product which sour gas became after the development of the sweetening process.

The fact that gas, unlike oil, is not sold on a day by day basis, but is usually sold under long term contracts, does not justify the rewriting of the definition of market price and the substitution therefor of "prevailing price."

The Tax Court opinion is the first reported case where the phrase "representative market or field price" has been applied to gas. The importance to the industry and the desirability of uniform application in the meaning of such phrase to various minerals justify the granting of the writ to settle the proper meaning of such phrase in relation to gas. If by virtue of the necessities of long term contracts for the sale of gas no representative market or field price is ascertainable by the comparative sales approach, then the necessity of determining a method for ascertaining the "gross income from the property" of the integrated producer-processor with respect to its gas is a matter of great importance that has not been but should be decided by this Court.

Bonus Issue

1. The decision below permits the levy of an income tax upon the return of capital in violation of Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution of the United States. The decision thereby necessarily conflicts in principle with *Eisner v. Macomber*, 252

U. S. 189, and directly conflicts in principle with *Burnet v. Harmel*, 287 U.S. 103, *Murphy Oil Co. v. Burnet*, 287 U.S. 299, *Anderson v. Helvering*, 310 U.S. 404, and *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25.

Eisner v. Macomber held invalid, as contravening the above cited provisions of the Constitution, a revenue statute imposing an income tax upon a stock dividend. This Court's succinct definition of income was stated in the opinion:

> "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through the sale or conversion of capital assets * * *."

Recognizing such definition to be insusceptible to literal application in solving all income questions, it nevertheless serves as a useful focal point in demonstrating the limits of the 16th Amendment to the Constitution as applicable here.

It is firmly established that the execution of an oil and gas lease is not, for federal income tax purposes, a sale or conversion of a capital asset.[14] We are not concerned here with income derived from labor. The quoted definition for our purpose is reduced therefore to "gain derived from capital."

The whole of the income here, that of both the lessor and the lessee, was derived from a single source—the oil and gas property which was leased. That property, frequently called a wasting asset,[15] is the only "capital" here involved, and the amount subject to tax to both the lessor and the lessee

[14] *Burnet v. Harmel*, 287 U.S. 103.
[15] *Anderson v. Helvering*, 310 U.S. 404.

cannot exceed the total gain derived from the dealings with that property.

Initially, the property was held solely by the lessor. There were numerous uses to which it then could have been committed to generate income. The owner might have received income from granting to another the right to make seismograph tests, to drill test holes, to make geological surveys or studies, or to prepare geological maps. There would be no determinable limit to the amount of income which might be derived in such ways. Similarly, if the oil and gas property were sold and resold, there would be no limit to the possible income that could be properly subjected to tax. The income derived from these unlimited methods of producing income, which do not exhaust the asset itself, might be called "ancillary income." On the other hand, the owner may have elected to develop and produce the oil or gas himself thereby exhausting the asset and producing income which could be called "primary income." This income is definitely limited to a particular amount. The property or "capital" can properly be considered a dual source of income, one type limited and the other not.

When the owner executes an oil and gas lease, he grants to the lessee various rights, including the right to enter upon and exploit the land and to produce oil and gas therefrom, but he has not made a sale.[16] If the lessor is paid a cash bonus, for what then is he being paid? If it is for the right granted to the lessee to enter, explore and test, and to do all things incidental to locating the minerals and preparing

[16] *Burnet v. Harmel*, supra.

for their production,[17] the *source* of the income (bonus money) is the same as if the owner, without executing the lease, had been paid merely for granting the right, let us say, to make a geological study. If this were the case, the source of the income would be the unlimited type and the bonus would simply be "ancillary income."

This Court has held time and again, however, that the bonus payment, when the lease does not terminate without production, is an *advance royalty*[18] for which the lessor is entitled to a depletion deduction.[19] The lessor is being paid for, though in advance of, actual production, and if there is none, the payment loses its character as a royalty and the depletion deduction is restored by the lessor.[20] If there is production, the bonus remains at all times an advance royalty and, as such, is a payment for the oil or gas produced. This being so, the bonus is income of the type characterized as "primary income" and neither it nor its source can be enlarged. There is a limited amount of income from this source which can be taxed under the Constitution whether received by one taxpayer or shared by many.

Typically the lessor holds a one-eighth royalty interest and the lessee holds the full seven-eighths working interest.

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[17] The fact that these various rights are granted to the lessee under local property law should not be considered. The same rights are granted when no bonus is paid.

[18] The terminology is of no importance. The critical point, whatever the bonus is called, is that it is afforded exactly the same tax treatment to the lessor as the payment of an actual royalty.

[19] *Murphy Oil Co. v. Burnet*, 287 U.S. 299; *Palmer v. Bender*, 287 U.S. 551; *Anderson v. Helvering*, 310 U.S. 404.

[20] *Douglas v. Commissioner*, 322 U.S. 275.

If the well produces oil which is sold for $800,000.00, that amount is the maximum which constitutionally can be included in the income of both taxpayers. Now, if the lessor has received a $100,000.00 bonus in advance of production, he in fact has received part of that $800,000.00. The decisions of this Court unquestionably establish this by treating the bonus in all respects as a royalty received by the lessor. There remains only $700,000.00 subject to inclusion in the income of the lessor and the lessee. Yet, under the holding of the Court below, when the oil is produced and sold, the lessor includes another $100,000.00 in his income as his one-eighth royalty and the lessee is required to include $700,000.00 in his income. The total income is enlarged by the amount of the bonus paid although there is no "ancillary income" involved. The constitutional limit on the income from this source is $800,000.00, yet $900,000.00 is subjected to tax by the decisions below. The lessor properly includes $200,000.00. The lessee properly can be required to include only $600,000.00, since the other $100,000.00 is not income but is a return of capital to him. He has paid the $100,000.00 royalty to the lessor in advance of production; that amount has been *substituted* at the beginning *for actual production* to be received later. Now that there is production the lessee is entitled to replace the $100,000.00 which was initially substituted for the production.

It might be argued that characterization of the bonus as *advance royalty* to the lessor is solely and simply for the pur-

pose of determining the tax treatment to him and has nothing to do with the constitutional limit of income to both the lessor and the lessee. The tax treatment to the lessor as settled by the decisions of this Court, however, is of critical and controlling importance since those decisions *identify and establish the source* of the income. If the lessor had been held to have made a sale or if he had been denied depletion on the bonus received, the lessee would have been paying for rights which created "ancillary income." In that event the lessee, of course, would be required to include in income his full fractional share of production since the *entire production and the total depletion deduction* would still be intact for division between the two parties.

Assume that A owns mineral properties and B has the knowledge and means to develop them and believes from geological studies that he can produce $800,000.00. It is agreed that A is to receive $200,000.00 of the expected production and B is to have the other $600,000.00, but it is also provided that B must pay to A at the time the lease is executed $100,000.00 as an advance on his share. A agrees that if production is not obtained the $100,000.00 will be returned to B, and if there is production B is to be repaid the $100,000.00 from A's $200,000.00 share. When a total of $800,000.00 is actually realized from production, there would be no contention that the maximum income from the endeavor exceeds $800,000.00. The $100,000.00 advanced by B to A is simply being returned when B receives $700,000.00 of the production.

The Government would say, however, that the $100,000.00 in the above illustration was paid *conditionally* whereas the bonus paid under the typical oil and gas lease is paid *unconditionally*. It is correct that *the amount of money* paid as bonus under the typical lease is paid unconditionally, but it cannot be said that such money *as advance royalty* is paid unconditionally. On the contrary, the *advance royalty* is in fact conditional upon production. If the lease terminates without production, the bonus money received by the lessor immediately loses its characterization as advance royalty and the depletion previously taken must be restored to income.[21] When this occurs, the oil and gas property has produced "ancillary income." Until it occurs, there is only "primary income" which cannot be enlarged.

The fact that a lessee is actually penalized by payment of a bonus graphically points out that the income tax is being levied upon capital. If there is production totaling $800,000.00 under the typical ⅛th - ⅞ths lease, the lessee who pays a $100,000.00 bonus is entitled to a percentage depletion deduction equal to 27½% of $600,000.00, whereas the lessee who pays no bonus receives a percentage depletion deduction equal to 27½% of $700,000.00. A bona fide business expenditure made to generate taxable income results in the imposition of a tax penalty against the lessee *because he is taxed on a return of capital.*

Such a result, permitted by the decision below, is forbidden by the Constitution and could not be possible if the

[21] *Douglas v. Commissioner*, supra.

principle announced by this Court in *Burton-Sutton Oil Company v. Commissioner* is applied. There the question for decision was whether the taxpayer operating company was entitled to exclude from its income the amount which it paid to the owner of a "net profits" interest. To answer the question this Court determined that the *holder* of the "net profits" interest had an economic interest in the oil and gas so as to entitle him to a depletion deduction. A decision on the character of the net profits interest to the *holder* thereof governed the Court's characterization of the net profits interest to the taxpayer payor. The test there laid down by this Court is:

> "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other."

This Court in *Burton-Sutton* not only enunciated such test but carefully applied it to the facts of that case. Its application is required here to avoid an unconstitutional levy of tax upon capital.

2. If neither the Constitution nor the principles announced by this Court entitle the lessee to exclude the bonus in determining taxable income, petitioner submits that he cannot properly be required to exclude the identical payment from his base for applying percentage depletion. If the result below is permitted to stand, the same bonus payment not only differs in nature as between a lessor and lessee but it also becomes two different things as to the lessee alone.

The governing statute[22] directs that the depletion deduction "shall be *equitably* apportioned between the lessor and lessee" (emphasis supplied). The very terms of this statute simply cannot be met unless both the lessor and the lessee receive a fair portion of the depletion deduction. Whether the lessee receives that fair share of the deduction is directly dependent upon how he treats the bonus payment *in determining taxable income.* That treatment and the lessee's treatment of the bonus in *applying percentage depletion* are not two separate and distinct problems which can be resolved satisfactorily independently of the other.

In the illustrative case of the 1/8th-7/8ths lease with a $100,000.00 cash bonus and total production of $800,000.00, the decision below would require that $900,000.00 be included in the gross incomes of the lessor and the lessee. The lessor would include $200,000.00 in income and would compute percentage depletion on that amount. The lessee would include $700,000.00 in income but would compute percentage depletion on only $600,000.00. The "equitable apportionment", as so applied, means that the amount of the bonus paid by the lessee is apportioned entirely to the lessor, and entirely from the lessee, while at the same time denying the lessee the right to exclude the bonus payment in arriving at taxable income.

If the lessee is permitted to exclude the amount of the bonus paid in arriving at taxable income, such apportionment of the entire bonus from the lessee is equitable. This is true because the bonus is treated as a return of capital to

[22] Sec. 23(m) Internal Revenue Code 1939.

the lessee, and the total amount to be apportioned does not exceed actual production. The apportionment of $200,000.00 to the lessor and $600,000.00 to the lessee is therefore in exact proportion to their interests.

When, however, the lessee in computing taxable income is not allowed to exclude the $100,000.00 bonus payment as a return of capital, there is necessarily a holding that the oil and gas property has produced income to the extent of $900,000.00, being the total of actual production plus the amount of the bonus. The result is that the lessee is required to include $700,000.00 in gross income. When this result is *combined* with the holding that the $700,000.00 gross income to the lessee must be reduced by the $100,000.00 bonus before applying percentage depletion, violence is done to the statutory direction of fair apportionment.

The inequity which results to the lessee under a statute which speaks expressly in terms of equity, evidenced by the actual *tax penalty* imposed upon the lessee who pays a bonus, raises an important issue of statutory construction which warrants consideration by this Court.

3. The widespread practice of bonus payments and the importance throughout the oil and gas industry of the application of sound and consistent principles of taxation to bonus payments that do not violate constitutional provisions warrant a determination by this Court of the issue presented.

CONCLUSION

For the foregoing reasons, petitioner respectfully submits that this Petition for Writ of Certiorari should be granted.

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CERTIFICATE OF SERVICE

I, W. M. SUTTON, one of the attorneys for The Shamrock Oil and Gas Corporation, petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the ..... day of August, 1965, I served copies of the foregoing Petition for Writ of Certiorari upon the Solicitor General, Department of Justice, Washington 25, D. C., by air mail, postage prepaid, and upon counsel of record who represented the Commissioner of Internal Revenue, respondent herein, in the court whose judgment is sought to be reviewed, in accordance with paragraph 2(a) of Rule 33 of the rules of this Court.

.....

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APPENDIX

INTERNAL REVENUE CODE 1939:

Sec. 23:

"In computing net income there shall be allowed as deductions:

* * * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

"For percentage allowable under this subsection, see section 114(b), (3) and (4)."

Sec. 114(b)(3):

"(3) Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from

such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

Reg. 111, Sec. 29.23(m)-1(f):

"(f) The term 'gross income from the property', as used in sections 114(b)(3) and 114(b)(4)(A) and sections 29.23(m)-1 to 29.23(m)-19, inclusive, means the following:

"In the case of oil and gas wells, 'gross income from the property' as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * * *

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years, or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from 'gross income from

the property' for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 29.23(m)-10(e)."

Reg. 111, Sec. 29.23(m)-10(a):

"Reg. 111, Sec. 29.23(m)-10. Depletion—Adjustments of accounts based on bonus or advanced royalty.—(a) * * * In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance."

Reg. 118, Sec. 39.23(m)-1(e):

"(e) As used in sections 114(b)(3) and 114(b)(4)(A) and secs. 39.23(m)-1 to 39.23(m)-19, inclusive, the term 'gross income from the property' means the following:

"(1) In the case of oil and gas wells, 'gross income from the property,' as used in section 114(b)(3), means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation."

Reg. 118, Sec. 39.23(m)-1(f)(5):

"(5) In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.' If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years, or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall

be an amount equal to that part of such payments which is allocable to the product sold during the current taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from 'gross income from the property' for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to sec. 39.23(m)-10(e)."

Reg. 118, Sec. 39.23(m)-10(a):

"Reg. 118, sec. 39.23(m)-10. Depletion; adjustments of accounts based on bonus or advanced royalty. (a) * * * In the case of the payor any payment made for the acquisition of an economic interest in a mineral deposit or standing timber constitutes a capital investment in the property recoverable only through the depletion allowance."

In the

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21067

THE SHAMROCK OIL & GAS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of Decisions of the Tax Court of the United States.

(June 7, 1965.)

Before HUTCHESON, Circuit Judge, WHITAKER,* Senior Judge, and RIVES, Circuit Judge.

HUTCHESON, Circuit Judge: The petitioner here seeks reversal of two Tax Court decisions. The first determines petitioner's "gross income from the property" for the purposes of computing its depletion allowance for the fiscal years 1943 through 1954 with respect to natural gas produced by the petitioner and in which it owned an economic interest. The second concerns the tax treatment in the hands of petitioner of cash bonuses or initial payments paid by it for the original acquisition or assignment of

*Of the United States Court of Claims, sitting by designation.

oil and gas leases to lessors or assignors who retained an economic interest in the property involved. This second decision relates only to the fiscal years 1948 through 1954.

Depletion Issue

Shamrock is an integrated oil company which produces and processes natural gas from leases in which it owns an economic interest. During the taxable years in question it made no substantial sales or deliveries of raw gas at the wellhead, but gathered the gas to central gasoline extraction plants and sold it after processing. The producing wells were connected to the gasoline plants through a gathering system which extended from one to 25 miles, depending upon the well's location on the reservoir.

At the gasoline plants the raw gas was run through two types of processing, absorption and fractionation. When the gas entered the plants it went first to the absorber. There the raw gas was run through a light absorption oil which took out the liquefiable hydrocarbons, leaving residue gas which constituted about 95 percent of the volume of the original raw gas. During the years in question the major portion of Shamrock's production consisted of sour gas, so designated because of its sulphur content. During the first taxable years this sour gas was sold for use in carbon black plants because the sulphur made it unsuitable for heating and light purposes. In the later years the Girbitol process was used to remove the hydrogen sulphide, or "sweeten" the gas, so that it could be sold for heating and light purposes. The residue gas was sold after it had been

run through the absorption process, and in later years the Girbitol process as well.

As they left the absorber, the liquid hydrocarbons extracted from the raw gas were contained in the light absorption oil used in the process. This mixture was run through a "still" which extracted the liquid hydrocarbons from the absorption oil. The liquids were then put through a fractionation process which, through a combination of pressure and temperature control, separated the propane, butane, isobutane, pentane, isopentane, and hexanes-plus. Each liquid, because of its particular vapor pressure characteristics, was boiled off at a given temperature and pressure. This process was repeated until all of the desired liquids had been extracted. Shamrock sold the liquids at this point, after they had been run through the absorption and fractionation processes.

In its original income tax returns, Shamrock computed its percentage depletion deduction on the basis of a determination of the price of gas produced at the wellhead, through a "proportionate profits" or "work back" method. It started with the proceeds from the sale of the residue gas and the liquid hydrocarbons and subtracted from that total the following: (1) a 6% return on its investment in the processing plants, (2) plant operating expenses, and (3) gathering costs. The Commissioner disagreed in part with the method and price used by Shamrock and determined deficiencies. Shamrock's petition in the Tax Court challenged the Commissioner's determination.

The applicable regulation pertaining to depletion of oil and gas wells [Treasury Regulations 118 (1939 Code), Sec. 39.23(m)-1(e)] provides that "gross income from the property" as used in the depletion provision of the statute means:

> "the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation."

The Tax Court held that Shamrock's "gross income from the property" was to be determined by applying the "representative market or field price" since it found that Shamrock made no significant actual sales "in the immediate vicinity of the well". It further found that there was a "representative market or field price" in the gas field in question and that it should be determined by computing a weighted average of actual prices paid at the wellhead during the years in question by purchasers of raw gas. The components of that weighted average were the prices paid by the petitioner for gas purchased from the working interests of others, the prices paid by the petitioner for casing-head gas, the prices paid for gas purchased by the petitioner under miscellaneous contracts, and the prices paid by interstate pipeline companies for raw gas delivered at the wellhead.

On appeal, Shamrock asserts nine errors pertaining to the depletion issue. These, in summary, boil down to four

basic contentions: (1) the Tax Court erred in refusing to hold that Shamrock's depletion base should be calculated by the "proportionate profits" method, (2) it was error to use the "representative market or field price" in this case because there were not a sufficient number of comparable sales of gas upon which to establish the price, (3) in the alternative, if the representative price is to be used, the Tax Court erred in excluding certain sales contracts and in including others, (4) the Tax Court erred in treating the absorption process in the gasoline plants of the taxpayer as a manufacturing activity, as opposed to holding the process was a part of production.

As to the depletion issue we are of the firm conviction that the Tax Court's exhaustive opinion, reported at 35 T.C. 979, properly disposed of all of the contentions asserted by petitioner. We accordingly adopt that opinion and affirm its decision on that issue. No good purpose would be served by restating here the complex and detailed facts which are so carefully developed in the Tax Court opinion or the many authorities upon which it relied. In addition to the Tax Court opinion in this case, an excellent discussion of the weighted average method of computing the "representative market or field price" is contained in *Hugoton Production Co. v. United States*, 315 F. 2d 868 (Ct. of Claims 1963), which relied in part upon the Tax Court's decision in this case.

Shamrock contends quite vigorously that the Tax Court's findings and conclusions that the processing activities conducted in their gasoline plants were manufacturing activities

conflict with this Court's decision in *Weinert's Estate*, 294 F. 2d 750 (5th Cir. 1951) which was rendered some five months after the Tax Court filed its findings and opinion. We do not agree. Both *Weinert's Estate* and *Scofield v. La Gloria Oil & Gas Co.*, 268 F. 2d 699 (5th Cir. 1959), upon which the statement concerning the absorption process as a part of production was based, involved cycling operations in which the absorption process constituted an indispensable part of the severance of the raw gas produced. In both cases the liquid hydrocarbons were extracted from the raw gas and the dry gas remaining was injected back into the reservoir in order to maintain pressure. The cycling plants, which contained absorption facilities, were essential for continuing production of gas from the wells. Without them, maximum recovery of the heavier hydrocarbons in the high pressure reservoirs would have been impossible because of retrograde condensation caused by reduced reservoir pressure. As the Court stated in *Weinert*,

> "Here, the plant was not a separate manufacturing plant or business, but an indispensable part of the severance and sale of the gas and liquid hydrocarbons produced from the unitized leases."

Shamrock's facilities involved no cycling operation. Although the absorption process here may have been essential from a marketing viewpoint, it was in no sense essential to *production*, any more than it can be said that the fractionation process was essential to production. Both were designed and operated to separate the raw gas into its various component parts for marketing purposes. What Shamrock produced was raw gas. The fact that it separated this raw

gas into residue gas and liquid hydrocarbons, and then separated the liquid hydrocarbons into their various components, does not mean that production ended at the termination of the processing, or at some stage during that processing. The absorption process used by Shamrock was clearly not an element of production, but was merely one of the steps in the manufacturing processes used by an integrated oil company in marketing the gas it produces. The Tax Court correctly looked to the "representative market or field price" for sales of raw gas at the well head, treating Shamrock as it would any other producer, without allowing it a larger depletion base just because it happens to be an integrated manufacturer as well as a producer. *U.S. v. Cannelton Sewer Pipe Co.*, 364 U.S. 76 (1960).

Bonus Issue

All facts relative to the bonus issue are stipulated so that the only question here is whether or not the Tax Court correctly determined the law as to the tax treatment of bonuses in so far as the lessee-petitioner is concerned. The Tax Court held that the petitioner was required to report as gross income the full amount of its share of production income without deducting the bonuses paid to lessors. It also held that the petitioner must arrive at its depletion base for percentage depletion purposes by diminishing the amount of production income it received by the proportionate part of the bonus allocable to the production for each year.

Petitioner asserts here, as it did below, three alternative contentions. (1) It, as lessee, should be permitted to deduct or exclude the bonus payments in full from its gross income in the year they are paid. (2) If they are not deducted in full in the year paid, then a proportionate part of the bonus, based on the anticipated productive life of the lease, should be deducted from gross income. (3) If the bonuses are to be considered capital expenditures and the deduction from gross income denied, then petitioner should not be required to exclude the bonus payment from its depletion base.

Petitioner readily concedes that the decision of the Tax Court is supported by the direct holdings of no less than four Courts of Appeal, including this Court.[1] However, it contends that *Burton-Sutton Oil Co. v. C.I.R.*, 328 U.S. 25 (1946) overturned this long-established tax treatment, and that this Court has so held in *Lambert v. Jefferson Lake Sulphur Co.*, 236 F. 2d 542 (5th Cir. 1956). We do not agree. The issue before the Court in *Burton-Sutton* involved only the question of whether the possessor of a right to a percentage of the net profits from production owned an economic interest in the oil in place and was thus entitled to a depletion deduction. The tax consequences to the lessee-payor of bonus payments, which is the sole issue here, was not before the Court in *Burton-Sutton* and the opinion there gives no reason to believe

[1] Murphy Oil Corp. v. United States, 337 F. 2d 677 (8th Cir. 1964), cert. denied 33 U.S.L.W. 3348, April 26, 1965; Canadian River Gas Co. v. Higgins, 151 F. 2d 954 (2nd Cir. 1945), cert. denied 327 U.S. 793; Sunray Oil Co. v. Commr., 147 F. 2d 962 (10th Cir. 1945), cert. denied 325 U.S. 861; Quintana Petroleum Co. v. Commr., 143 F. 2d 588 (5th Cir. 1944).

that the holding of that case requires the overruling of long-standing Treasury Regulations and prior decisions of the Courts of Appeals pertaining to the treatment of bonus payments.

Petitioner places great weight on this Court's decision in *Lambert v. Jefferson Lake Sulphur Co., supra*, as supporting its contention that it should be allowed to deduct the bonus payments from its gross income, either in full when paid, or in proportionate amounts based on the anticipated productive life of the lease. That case causes some confusion because the Court not only assigned its reasons for affirmance of the district court, but also adopted the district court's conclusions on the grounds assigned by it. In such a case we can only look to the nature of the payments involved. It seems clear that they were, as this Court characterized them, "in the nature of delay rentals", 236 F. 2d 542, 546, rather than bonus payments, although there is dicta to the effect that "even if the payments were installments of a bonus, they were nonetheless deductible". 236 F. 2d 542, 544, note 4. Although the holding that the payments were deductible as delay rentals is sound, to the extent that the dicta may be read as providing the same treatment to bonus payments, it is specifically rejected.

The basic fault in petitioner's case is its inability to point to any provision of the Code or of the Regulations which allows the deductions here sought. The burden is on the petitioner to point to the statutory provisions or valid administrative regulations which allow the deduction. Absent

such statutory provision it will not at all do to lift from myriad judicial opinions statements as to the nature of bonus payments and thereby create a deduction nowhere found in the Code itself. The real substance of petitioner's argument amounts to a contention that the present tax treatment of bonuses is unfair to lessees and should be changed.[2] This may well be a persuasive argument to the Congress where the enactment of remedial legislation could be accompanied by careful consideration of all of the complex interrelationships involved in an oil and gas lease arrangement, but legislating is not the function of this Court. As the case reaches this Court it is the taxpayer's burden to overcome the Commissioner's determination by reference to statute or regulation which supports its claim. Instead of being able to do so, as the Tax Court's opinion points out, the statute and the regulations support not the petitioner's claim, but rather, that of the Commissioner.

The Tax Court having properly disposed of all issues in the case, its decisions must be, and are hereby, AFFIRMED.

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[2] See for example, Hughes, Tax Consequences to Lessee of Bonus Paid for an Oil and Gas Lease, 11th Annual Institute on Oil & Gas Taxation 487 (S.W. Legal Foundation 1960) which is cited extensively by petitioner. Mr. Hughes' final conclusion is as follows:

> "But undoubtedly the most desirable course would be corrective legislation affording to the bonus a tax treatment, from the standpoint of both lessees and lessors, which more nearly recognizes its true character, i.e., a capital payment and not an advance royalty." *Id.* at 518.

United States Court of Appeals
FOR THE FIFTH CIRCUIT

October Term, 1964

No. 21067

T. C. Docket Nos. 49145, 61315, 68580 and 77791

THE SHAMROCK OIL & GAS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decisions of the Tax Court of the United States.

Before HUTCHESON, Circuit Judge, WHITAKER,* Senior Judge, and RIVES, Circuit Judge.

JUDGMENT

This cause came on to be heard on the petitions of the Commissioner of Internal Revenue for review of decisions of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decisions of the Tax Court in this cause be, and the same are hereby, affirmed.

June 7, 1965

Issued as Mandate:

*Of the United States Court of Claims, sitting by designation.

In the

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21067

THE SHAMROCK OIL & GAS CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decisions of the Tax Court of the United States.

(July 9 , 1965)

On Motion for leave to file brief amicus curiae
AND
On Petition for Rehearing

Before HUTCHESON, Circuit Judge, WHITAKER,* Senior Judge, and RIVES, Circuit Judge.

PER CURIAM:

IT IS ORDERED that the Motion of Vester T. Hughes, Jr. for leave to file brief amicus curiae in the above-entitled and numbered cause be, and the same is hereby GRANTED.

IT IS FURTHER ORDERED that the Petition for Rehearing filed in the above entitled and numbered cause be, and the same is hereby DENIED.

*Senior Judge, United States Court of Claims, sitting by designation.

United States Court of Appeals
FOR THE FIFTH CIRCUIT

No. 21067

THE SHAMROCK OIL & GAS CORPORATION,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON CONSIDERATION OF THE APPLICATION OF THE Petitioner in the above numbered and entitled cause for a stay of the mandate of this court therein, to enable Petitioner to apply for and to obtain a writ of certiorari from the Supreme Court of the United States, IT IS ORDERED that the issue of the mandate of this court in said cause be and the same is stayed for a period of thirty days; the stay to continue in force until the final disposition of the case by the Supreme Court, provided that within thirty days from the date of this order there shall be filed with the clerk of this court the certificate of the clerk of the Supreme Court that certiorari petition and record have been filed. It is further ordered that the clerk shall issue the mandate upon the filing of a copy of an order of the Supreme Court denying the writ, or upon the expiration of thirty days from the date of this order, unless the above-mentioned certificate shall be filed with the clerk of this court within that time.

DONE AT NEW ORLEANS, LA., this 15th day of July, 1965.

/s/ J. C. Hutcheson, Jr.
United States Circuit Judge.

(ORIGINAL FILED JULY 16, 1965)